Internal Revenue Service

memorandum

CC:TL:TS
JEHELKE 5919-88

date: 08 JUL 1988

to: District Counsel, Manhattan NA:MAN
Attn: Sharon Katz-Pearlman

from: Director, Tax Litigation Division CC:TL

---

subject: Request for Technical Advice
Proper Treatment of Favorable Financing in I.R.C. § 338 Acquisitions

ISSUE:

Whether a corporation, which assumes a target corporation's outstanding notes with below market interest rates, has acquired an amortizable intangible asset ("favorable financing") equal in value to the present value of the purported interest savings on the notes.

FACTS:

This request arises from a Leveraged Buyout ("LBO") Conference in New York during which the proper treatment of outstanding notes payable acquired in a I.R.C. § 338 acquisition was discussed. Taxpayers have claimed deductions relating to the amortization of such below market financing.

DISCUSSION:

In order to try to quantify the universe of "favorable financing" in large cases, National Office Exam, with our assistance, has sent a survey to all large case managers requesting a listing as to which cases have this issue. Once we have received a response to this survey, we will determine which cases also have above market debt assumed by an acquiring company ("unfavorable financing") in an effort to pinpoint the best cases for development.

The Office of Chief Counsel has been analyzing the proper way to treat such acquisition of below market liabilities. It is felt that we should look at the overall economics of the transaction and not just focus on the tax aspects..

008552

One point of inquiry is whether a below market rate loan is an asset used in a trade or business since loans are, generally, shown as liabilities, not assets on balance sheets. Assuming, for discussion purposes that "favorable financing" could be treated as an intangible asset, then it must have an ascertainable value separate and distinct from goodwill and have a limited useful life.

Another approach is to treat such financing under the original issue discount or bond premium rules. This technical theory then leads to questions as to whether the seller receives income under cancellation of debt or tax benefit principles. We have been studying this approach and have been reviewing it with economists.

Further, one could argue that if "favorable financing" creates a deduction, then the assumption of "unfavorable financing" creates income to they buyer. Treatment to the seller is also a question. In order to truly demonstrate the tax and economic effects of "favorable financing" both fact patterns should be developed.

CONCLUSION:

At this time, we are looking for a case with both "favorable" and "unfavorable" financing as a litigating vehicle.

If a case is to be developed, the following areas should be addressed:

1. Is the market rate of interest at the time of acquisition greater or less than the interest rate on the debt issue assumed?

2. Can the amortizable period be established with reasonable accuracy?

3. On any debt assumed, has the taxpayer demonstrated the true economic cost of the debt?

4. What economic assumptions did the taxpayer make with respect to the issuance of new debt (type, maturity, etc.) to come up with the differential between it and the debt assumed?

5. When a taxpayer determined the "value" of the "favorable financing," did the analysis include how much income would be generated and, therefore, additional taxes paid, as a result of the interest cost saved?

6. Have the credit ratings of the acquiring and target company been reviewed to determine whether the interest rates claimed are reasonable?

7. In planning the acquisition, did the acquiring company analyze the target's debt cost?

The tax and economic questions are complex. Any litigation vehicle will need extremely detailed development. As you work with Exam in developing a case and preparing informal document requests, we will assist you as requested.

If you would like to discuss this issue further, please call Joel Helke at FTS 566-4369.

MARLENE GROSS

By: Joel E Helke
JOEL E. HELKE
Special Counsel
(Commodities and Financial Products)